# ASSOCIATION EXAMINATION REPORT

# OF THE

# ROYAL INDEMNITY COMPANY

# AS OF

# DECEMBER 31, 2004

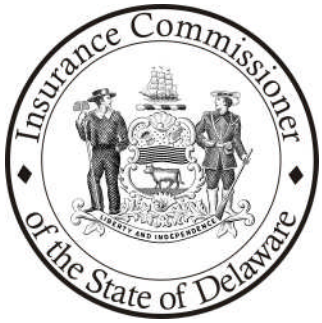
I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of DECEMBER 31, 2004 of the

**ROYAL INDEMNITY COMPANY**

is a true and correct copy of the document filed with this Department.

ATTEST BY: _____

DATE: 22 JUNE 2006




*In Witness Whereof,* I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 22ND DAY OF JUNE 2006.

_____

*Insurance Commissioner*

**REPORT ON EXAMINATION**

OF THE

**ROYAL INDEMNITY COMPANY**

AS OF

**December 31, 2004**

The above captioned Report was completed by examiners of the Delaware Insurance Department.

Consideration has duly been given to the comments, conclusions, and recommendations of the examiners regarding the status of the Company as reflected in the Report.

This Report is hereby accepted, adopted, and filed as an official record of this Department.

_____

MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 22ND Day of JUNE 2006.

# TABLE OF CONTENTS

## SALUTATION

February 1, 2006

Honorable Alfred W. Gross
Chairman, Financial Condition (E)
Committee, NAIC
State Corporation Commission
Bureau of Insurance
Commonwealth of Virginia
1300 East Main Street
Richmond, VA 23219

Honorable Julie Bowler
Secretary, Northeastern Zone, (I), NAIC
Division of Insurance
Commonwealth of Massachusetts
One South Station, 5th Floor
Boston, MA 02110

Honorable Matthew Denn
Commissioner of Insurance
State of Delaware
941 Silver Lake Blvd.
Dover, DE 19904

Honorable Walter Bell
Secretary, Southeastern Zone (II), NAIC
Alabama Department of Insurance
201 Monroe Street, Suite 1700
Montgomery, AL 36104

Honorable Jorge Gomez
Secretary, Midwestern Zone (III), NAIC
Office of the Commissioner of Insurance
State of Wisconsin
125 South Webster Street
GEF III – 2nd Floor
Madison, WI 53702

Honorable John Morrison
Secretary, Western Zone (IV), NAIC
Montana Department of Insurance
840 Helena Avenue
Helena, MT 59601

Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority No. 05.005, dated February 4, 2005, an Association examination has been made of the affairs, financial condition and management of the

**ROYAL INDEMNITY COMPANY**

hereinafter referred to as "Company", incorporated under the laws of the State of Delaware as a stock company with its home office located at 2711 Centerville Road, Suite 400, Wilmington, Delaware. The examination was conducted at the main administrative office of the Company, located at 9300 Arrowpoint Boulevard, Charlotte, North Carolina.

The report of such examination is submitted herewith.

## SCOPE OF EXAMINATION

The last examination was conducted as of December 31, 2001. This examination covered the period from January 1, 2002 through December 31, 2004, and consisted of a general survey of the Company's business policies and practices, management, and corporate matters incident thereto, a verification and evaluation of assets and a determination of liabilities. Transactions subsequent to the latter date were reviewed where deemed necessary.

This report is presented on an exception basis. It is designed to set forth the facts with regard to any adverse findings disclosed during the examination. If necessary, comments and recommendations have been made in those areas in need of correction or improvement. In such cases, these matters were thoroughly discussed with responsible personnel and/or officials during the course of this examination.

The general procedures of the examination followed the rules established by the Committee on Financial Condition Examiners Handbook of the National Association of Insurance Commissioners (NAIC) and generally accepted statutory insurance examination standards consistent with the Insurance Laws and Regulations of the State of Delaware. In accordance with the aforementioned Handbook, the consulting firm of INS Services, Inc. performed an information systems review.

The 2004 examination was conducted in accordance with the Association Plan of Examination guidelines established by the National Association of Insurance Commissioners. The State of Connecticut, the State of Colorado, the State of New York and the State of California (Western Zone) participated in the examination.

## HISTORY

On December 3, 1979, the Company was incorporated under the laws of the State of Delaware as a stock property and casualty insurance company. The Company was used to transfer the corporate domicile of its former immediate parent company, Royal Indemnity Company, from the State of New York to the State of Delaware on March 31, 1980.

By consent to action by the sole shareholder and through a special meeting of the Board of Directors, the Company and its immediate parent entered into a merger agreement to become effective with the approval of the Commissioners of the States of Delaware and New York. The surviving corporation, Royal Indemnity Company, a Delaware corporation, assumed all assets, liabilities, rights, privileges, immunities, powers and franchises of both companies. Approved by the Commissioners of the States of Delaware and New York, the merger became effective March 31, 1980.

On July 17, 1996, the Company's ultimate parent, Royal Insurance Group plc and SunAlliance Group plc, a United Kingdom entity, merged and became known as Royal & SunAlliance Insurance Group plc.

In November 1999, the group acquired Orion Capital Corporation, a specialty personal and commercial lines writer for $1.4 billion plus the assumption of approximately $460 million in outstanding debt.

Effective December 31, 2004, Phoenix Assurance Company of New York was merged into Royal Insurance Company of America. Royal Insurance Company of America along with American and Foreign Insurance Company and Globe Indemnity Company were then merged into Royal Indemnity Company.

## CAPITALIZATION

Common Capital Stock

As of December 31, 2004, 50,000 shares authorized, issued and outstanding at $100 par value represented the Company's common capital stock, for a total Capital Paid Up of $5,000,000. Royal Group, Inc. (a Delaware corporation) owns 100% of the outstanding stock. Royal Group, Inc. is in turn ultimately owned by Royal & Sun Alliance Insurance Group plc, (a United Kingdom company).

During this period of examination, there were no changes in ownership or to the Company's Certificate of Incorporation.

Gross Paid In and Contributed Surplus

As reported in the prior Report on Examination as of December 31, 2001, gross paid in and contributed surplus amounted to $767,093,740. On December 12, 2002, Royal Group, Inc. declared a capital contribution in the amount of $95,000,000 to be made to the Company, which was paid in the form of cash on December 19, 2002. Also, on December 17, 2002, Royal Group, Inc. declared a capital contribution in the amount of $95,000,000 to be made to the Company. This capital contribution was separately shown on the asset page of the annual statement as of December 31, 2002 in the Aggregate write-ins for other than invested assets as "Receivable from Parent – Capital Contribution." On February 27, 2003, the receivable was settled and the Company received $95,000,000 in cash and securities from Royal Group, Inc.

Capital contributions from Royal Group, Inc. to the Company in the amounts of $18,500,000 and $186,500,000 were declared on December 15, 2003 and December 19, 2003, respectively. These capital contributions are reflected on the Asset page of the annual statement

as of December 31, 2003 in the Aggregate write-ins for other than invested assets as "Receivable from Parent – Capital Contribution." On February 26, 2004, the receivable was settled and the Company received $205,000,000 in cash from Royal Group, Inc.

The following transaction occurred on the books of American and Foreign Insurance Company in 2003. Due to the merger, the transaction is included in the financial statements of the Company. A capital contribution from Royal Group, Inc. to the Company in the amount of $18,500,000 was declared on December 15, 2003 and was paid on February 26, 2004.

The following transaction occurred on the books of Globe Indemnity Company in 2003. Due to the merger, the transaction is included in the financial statements of the Company. A capital contribution from Royal Group, Inc. to the Company in the amount of $3,000,000 was declared on December 15, 2003 and was paid on February 26, 2004.

The following transactions occurred on the books of Royal Insurance Company of America in 2003. Due to the merger, the transactions are included in the financial statements of the Company. A capital contribution from Royal Group, Inc. to the Company in the amount of $21,000,000 was declared on December 15, 2003 and was paid on December 29, 2003. Capital contributions from Royal Group, Inc. to the Company in the amount of $68,000,000 were declared on December 15, 2003 and were paid on February 26, 2004.

As a result of the merger of American and Foreign Insurance Company, Globe Indemnity Company, Royal Insurance Company of America, and Phoenix Insurance Company of New York into the Company, an increase of $891,235,361 to the Company's gross paid in and contributed surplus was made. This increase represents the historical capital contributions to the respective merged companies prior to 2003.

On December 16, 2004, Royal Group, Inc. declared a capital contribution in the amount of $20,000,000 to be made to the Company, which was paid in the form of cash on December 20, 2004.

As a result of the above transactions, at December 31, 2004, the Company's Gross Paid In and Contributed Surplus amounted to $2,183,829,100.

Special Surplus Funds

The Company and Royal & Sun Alliance Insurance plc, an affiliate, entered into an Aggregate Excess of Loss Reinsurance Agreement effective September 30, 2003. As an affiliated transaction, this agreement was subject to the Delaware Insurance Department's approval, which was received on December 23, 2003. As a condition of approval, the Company is required to segregate any increase in policyholders' surplus recorded as a result of this Agreement subsequent to its effective date. The Company, as a member of the Royal Insurance 1989 Reinsurance Pooling Agreement, has ceded 75% of this increase in policyholder's surplus through underwriting results. After the cession to the other Pool companies, the Company initially recorded a $133,550,000 increase in special surplus funds, which was subsequently increased by $186,970,000 as a result of the merger to the amount of $320,520,000 in 2003. During 2004, additional loss transactions required the Company to increase special surplus funds by $51,294,000, resulting in a total of $371,814,000 at December 31, 2004.

## MANAGEMENT AND CONTROL

Pursuant to the general corporation laws of the state of Delaware, as implemented by the Company's Certificate of Incorporation and bylaws, all corporate powers are exercised by or under the direction of a Board of Directors, which shall be determined by the shareholder.

During the period under review, the board of directors, as required, held three annual meetings as soon as practicable after the annual shareholders' meeting as well as seven special meetings. A quorum, or one-third of the number of directors fixed by the Board, is required. This is a change from the "majority" requirement before the Amendment and Restatement of By-Laws adopted on May 9, 2000. No changes occurred in the By-Laws during the current examination period of December 31, 2004. Directors' Committees existed as follows:

Executive Committee
Investment Committee
Conflict of Interest Committee
Pension and Benefits Committee
Policyholder Dividend Committee
Benefits and Advisory Committee

Directors duly elected and serving at December 31, 2004 and their residence locations are as follows:

| Name | Address | Business Affiliation* |
|---|---|---|
| John Tighe, (Board Chairman) | Charlotte, NC | Company President & CEO |
| Sean Beatty | Mooresville, NC | Senior VP & Chief Financial Officer |
| Dennis Cahill | Basking Ridge, NJ | Senior VP & Chief Operating Officer |
| Robert Dixon | Charlotte, NC | Senior VP & Chief Human Resource Officer |
| Andre Lefebvre | Merrimack, NH | Senior VP & Financial Risk Officer |
| Julie Welborn | Rock Hill, SC | Senior VP & Chief Claims Officer |
| James Williams III | Charlotte, NC | Senior VP & Chief Information Officer |

*All Directors are employed by Royal & SunAlliance, USA.

Officers

Pursuant to the Amended and Restated By-Laws adopted on May 9, 2000, the officers shall consist of a Chairman of the Board, a President, one or more Vice Presidents, any one or more of which may be designated Executive Vice President or Senior Vice President, a Secretary and a Treasurer. The Board of Directors may appoint such other officers, assistant officers and agents, as it shall deem necessary. With the exception of the President and Corporate Secretary, the same person may hold two or more offices.

The officers of the corporation shall hold office until their successors have been elected and qualified, or until their resignation or removal from office. The senior officers elected during 2004 and serving at December 31, 2004 were as follows:

| Name | Title |
|---|---|
| John Tighe | President & Chief Executive Officer |
| Sean Beatty | Senior VP & CFO |
| Dennis Cahill | Senior VP & Chief Operating Officer |
| Robert Dixon | Senior VP & Chief Human Resource Officer |
| Andre Lefebvre | Senior VP & Chief Financial Risk Officer |
| Julie Welborn | Senior VP & Chief Claims Officer |
| James Williams III | Senior VP & Chief Information Officer |
| David Davenport | VP & Controller |
| David Graham | VP & Chief Reinsurance Officer |
| David Shumway | VP & Chief Investments Officer |
| Daniel Keddie | VP & Chief Actuary Officer |
| Gwyn Fuller | Treasurer |
| Linda Young Pettigrew | Corporate Secretary |

It was determined that the Company had not been filing, within 30 days, notification of changes in its executive officers and directors. This exception was noted in the prior examination as well. Therefore,

**It is recommended that the Company make appropriate notifications of changes in its executive officers and directors as required by Section 4919 of Delaware Insurance Code.**

Shareholder Meetings

Shareholder(s) are required to meet on the last Wednesday in April at an hour fixed by the directors, unless it is a holiday, whereas the meeting will be the next day. The Articles of Incorporation were not amended during this examination. The bylaws were amended on May 9, 2000 and approved by the Delaware Insurance Department. Article IX provides the changing of the number of Directors from 13 to 21. The Company was found to be in compliance with the By-Laws during the three-year examination period.

Committees

The Executive Committee shall consist of three or more members of the Board of Directors, the number from time to time to be determined by the Board. The Board of Directors, by the affirmative vote of a majority of the directors, shall designate the members of the Executive Committee, one of whom may be designated as Chairman of the Executive Committee. During intervals between the meetings of the Board, the Executive Committee shall have and may exercise all the powers and authority of the Board of Directors in the management of the business and affairs of the Corporation (including the declaration of policyholder dividends) in all cases in which specific directions shall not have been given by the Board of Directors. Meetings may be called by the Chairman or any two of its members; and a majority of the members fixed by the Board shall constitute a quorum. Directors serving on the Executive Committee as of December 31, 2004 were:

Directors
John Tighe, Chairman
Sean Beatty
Dennis Cahill
Andre Lefebvre

Other committees consisting of at least three directors may be determined and their functions and duties prescribed by the Board of Directors. Each committee determines its own rules, must keep regular minutes of its meetings and report all actions taken to the Board. Other committees formed by the Board cover the business areas of Investment, Policyholder Dividends, Pension and Benefits, and Conflict of Interest.

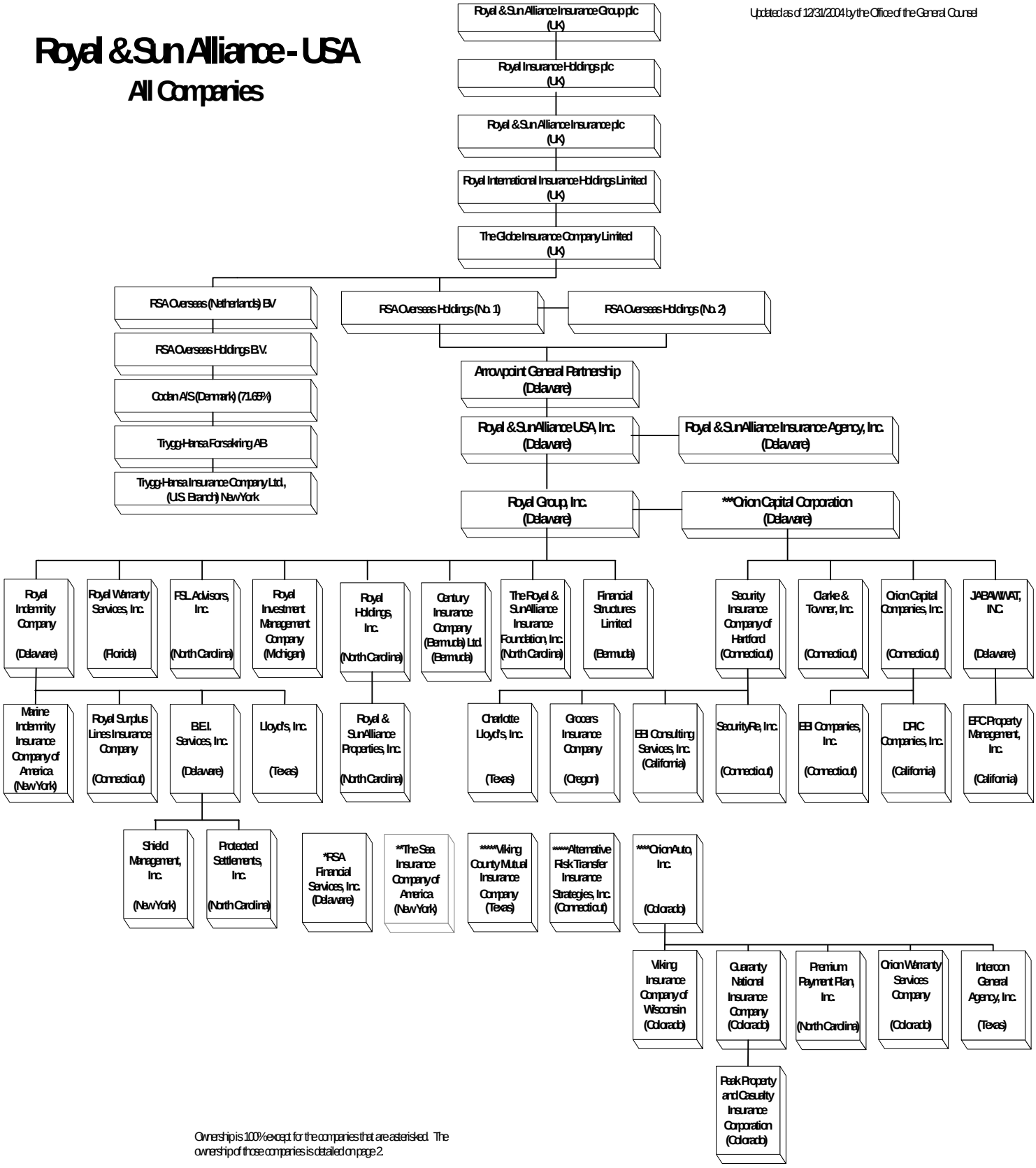
## HOLDING COMPANY SYSTEM

The Company is a member of an Insurance Holding Company System. The ultimate parent of the system is Royal & Sun Alliance Group plc (UK), existing under the laws of the United Kingdom of Great Britain. The following is an organizational chart that reflects the identities and interrelationships between the Company, parent, all affiliated insurers, and other members of the system as of December 31, 2004:

# Royal & Sun Alliance - USA

## All Companies

Updated as of 12/31/2004 by the Office of the General Counsel




Ownership is 100% except for the companies that are asterisked. The ownership of those companies is detailed on page 2.

# Royal & Sun Alliance - USA
## All Companies
## Page 2

Ownership of the Royal & SunAlliance companies is 100% except for the following:

*RSA Financial Services, Inc.:
Royal Indemnity Company - 87.7%
Security Insurance Company of Hartford - 12.3%

**The Sea Insurance Company of America:
Royal Indemnity Company - 90.0%
Security Insurance Company of Hartford - 10.0%

***Orion Capital Corporation:
Royal Group, Inc. - 92.2%
Security Insurance Company of Hartford - 2.7%
EFC Property Management, Inc. - 2.4%
SecurityRe, Inc. - 1.4%
Royal Indemnity Company - 1.0%
JABAWWAT, Inc. - 0.3%

****OrionAuto, Inc.:
Royal Indemnity Company - 57.9%
Security Insurance Company of Hartford - 42.1%

***** Viking County Mutual Insurance Company:
Owned by the policyholders; managed by Viking Insurance Company of Wisconsin

****** Alternative Risk Transfer Insurance Strategies, Inc.:
Orion Capital Companies, Inc. - 80%
Royal Group, Inc. - 20%

Copies of the "Form B Holding Company Registration Statements" filed with the Delaware Insurance Department during the period under examination were reviewed. Per the review, the Company has complied with the provisions of Regulation 13 of the Delaware Insurance Code.

## PLAN OF REORGANIZATION AND CONSOLIDATION

During the period since the prior examination, the holding company system implemented a Plan of Reorganization and Consolidation. The purpose of such plan was to reduce the number of operating insurance companies in the United States, thus reducing the expense of conducting business and to permit more efficient distribution of capital within the United States. There were various mergers and other transactions including payments of dividends and contributions of capital to companies within the system. The necessary filings with the Delaware Department of Insurance were made and approvals granted prior to effecting the transactions. A total of twenty-one (21) companies in the Royal SunAlliance Group were disposed of, either by merger, sale or dissolution, since January 1, 2002. As of December 31, 2004, the following companies were merged into Royal Indemnity Company:

American and Foreign Insurance Company
Globe Indemnity Company
Royal Insurance Company of America

## MANAGEMENT AND SERVICE AGREEMENTS

Agreements with Affiliates

As of December 31, 2004, the Company had the following service agreements in effect with its parents and affiliates:

- "Tax Allocation Agreement" effective December 31, 1999 between the Company, Arrowpoint General Partnership (Parent), Royal & SunAlliance USA, Inc. (RSA), Royal Group, Inc. (RGI), and the various "Subsidiaries" of Parent - The Parent owns directly or indirectly 100% of the outstanding capital stock of RSA, RGI, and the "Subsidiaries" and is the common parent of an "Affiliated Group" of corporations. The agreement provides for Parent, RSA, RGI and Subsidiaries to allocate among themselves the federal income tax liability of "Affiliated Group" and certain related matters with special provisions applicable to "Insurance Group Members" so as to be consistent with the requirements of New York Insurance Department Circular Letter No. 33 and other applicable state laws. It provides that each subsidiary contribute its fair share to the taxes payable by the Affiliated Group, with RGI acting as settlement intermediary and RSA acting as payment intermediary for Affiliated Group. Effective September 30, 2002 the agreement was amended to provide for the termination from the agreement of Royal & SunAlliance Personal Insurance Company and Connecticut Specialty Insurance Company, which were both sold to Axis Specialty U.S. Holdings, Inc. pursuant to a Stock Purchase Agreement dated March 14, 2002.

- "Investment Management Services Agreement" between the Company and affiliate, Royal Investment Management Company (RIMCO) effective January 1, 1998 - The agreement is to remain in effect until terminated. In accordance with the terms of the agreement, RIMCO shall, per investment guidelines, purchase, invest in or otherwise, acquire, sell, transfer, exchange or dispose of, and generally deal in and with any and all forms of investments on behalf of the Company's investment portfolio. The Company

will pay RIMCO a quarterly fee equal to four basis points (.0004) of the ledger value of the Company's account as of the previous quarter. Fees are to be paid by the Company within thirty (30) days of the invoice date. The subject agreement was amended September 11, 2000 to change the language regarding the established management fee under the contract. The agreement originally stated that the fee was established and paid quarterly. This was changed to read, "The investment management fees are established annually and paid quarterly."

- "Administrative Services and Expense Sharing Agreement" between Royal Indemnity Company (RIC) and its affiliates effective, January 2, 2001 - The agreement is for a term of one (1) year unless cancelled at any time by agreement of the companies. The agreement shall automatically renew for four (4) consecutive one-year terms. At the end of the fifth year, the Agreement will be terminated at which time the companies will enter into a new Agreement. In accordance with the terms of the agreement, RIC will provide certain services and allocate expenses to the companies under the agreement. Allocation of expenses will be based on the actual cost of the service received and used by the companies, or will be pro-rated or based on a pre-set formula using premium and other factors such as time spent. The allocation of the expenses will be no greater than that which a company would expend in providing services for its own company. Each company shall reimburse RIC within 30 days following the preceding quarter in an amount equal to the expenses paid by RIC for the preceding quarter. Effective September 30, 2002 the agreement was amended to provide for the termination from the agreement of Royal & SunAlliance Personal Insurance Company and Connecticut Specialty

Insurance Company that were both sold to Axis Specialty U.S. Holdings, Inc. pursuant to a Stock Purchase Agreement dated March 14, 2002.

Agreements with Non-affiliates

- "Service Agreement" with ACS Outsourcing Solutions, Inc. effective April 1, 2000 – Under this agreement ACS provides technology services, including electronic data processing, facilities management, systems integration, systems development, telecommunications, printing and mailing and related services. The term of the agreement runs from April 1, 2000 to expire March 31, 2007.

## TERRITORY AND PLAN OF OPERATION

The Company has certificates of authority and is licensed to do business in all states within the United States, including the District of Columbia, and Guam as of December 31, 2004. The Company reported direct business of $31,616,448 in 2004. During 2004, the Company wrote the largest amount of direct written premium in three states as shown in the following exhibit:

| State | Written Premium | Percent of Total Written Premium |
|---|---|---|
| Florida | $15,508,763 | 49% |
| Massachusetts | 4,884,382 | 15% |
| Pennsylvania | 10,308,913 | 33% |
| Total | $30,702,058 | 97% |

The Company wrote private passenger auto, and auto physical damage, which made up twenty-eight percent (28%) of direct insurance written. The Company operates through territorial branches and claims offices throughout the country. These offices operated on a semi-automated system. The non-standard auto business is nearly one hundred percent (100%) automated. In September 2003, the Company ceased writing new business, with exception of the non-standard auto business.

As of November 2, 2005, Royal & Sun Alliance Insurance Group plc, announced the completion of the sale of its US non-standard auto business to Sentry Insurance a Mutual Company after obtaining regulatory approval from the domiciliary states. The sale was completed on the originally agreed terms.

As a result of the 2003 restructuring that included the decision to cease writing new business, the sale of the renewal rights for the majority of the Company's business and the 2005 sale of the non-standard auto business, the Company's operations consist of a closed book of property and casualty business that is in run-off. In 2003, management implemented a strategy to stabilize the organization with the primary goal to meet policyholder obligations. This strategy is focused in risk management, governance and accountability. The Company's management identified six key drivers that are critical to meeting the US strategy. They are:

- Claims management – meet policyholders obligations and provide stewardship over corporate assets.
- Expense management – ensure that the expense base is commensurate with operational needs.

- Transition of resources and assets – mange consolidation of the US operations to a stabilized, cost effective, functionally aligned structure that can support continuing obligations.
- Legal – provide proper management and resolution of claims, corporate litigation and regulatory risk.
- Investment management – optimize asset type and maturity mix so that expected liability outflows are matched with equivalent investment asset inflows.
- Reinsurance recoverables – maximize the cash available to operations through aggressive reinsurance collections and cash management.

## GROWTH OF THE COMPANY

The following information was obtained from the Company's filed Annual Statements:

| Year | Admitted Assets | Surplus as to Policyholders | Gross Premiums Written | Net Income |
|---|---|---|---|---|
| **2004** | $4,774,041,704 | $ 893,538,458 | $ 591,769,604 | **$ (625,738,432)** |
| **2003** | 5,584,895,570 | 1,234,218,748 | 5,152,683,512 | (244,339,133) |
| **2002** | 2,456,034,355 | 547,928,078 | 4,643,009,102 | (126,535,586) |
| **2001** | 2,363,823,363 | 514,289,564 | 3,630,156,039 | (144,043,078) |

The Company has experienced mixed results and large variances during the period under examination. The Company incurred both growth in assets and surplus, but declines in premium and net income. Over the three-year examination period, the following took place:

- 102% increase in admitted assets.
- 74% increase in surplus as regards to policyholders.

- (84%) decrease in gross written premium.
- (334%) decrease in net income.

Overall, net admitted assets increased during the examination period due to capital contributions, an aggregate excess of loss contract, changes in the Company's reinsurance pooling agreement and mergers of affiliates into the Company. The Company's participation changed from 25% to 62% in the amended pooling agreement. The Company secured an irrevocable letter of credit in connection with an "Indemnification Agreement." The agreement secures payment to the Company of certain reinsurance recoverables, which increased surplus. The initial value of the Letter of Credit was $100 million, which was increased by an additional $50.0 million. The transaction resulted in an increase to statutory surplus of the Company $149.8 million and $146.0 million as of December 31, 2004 and December 31, 2003, respectively, through a reduction in the provision for reinsurance.

The Company's gross premium decreased by $4.56 billion or (88.52 %) during 2004. The overall decrease was due to the decision to cease writing new business and the sale of the renewal rights for the majority of the Company's business. The financial strength ratings of the Company were lowered in 2003 by all three of the major rating agencies. As of December 31, 2004, the ratings were as follows:

**1)** AM Best Rating - B (Negative outlook)
**2)** Standard & Poor - BB+ (Negative outlook)
**3)** Moody's Rating - Ba3 (Negative outlook)

The net income decline and the deterioration of the Company has been caused by events such as the World Trade Center tragedy, weakened capital markets performance, adverse loss development on business written, acceleration in the level of asbestos claims, and the increase in the IBNR reserve for the asbestos and environmental claims, and workers compensation claims.

The Fleet Consolidation Plan was implemented and utilized by the Company to reduce the number of companies in its fleet of companies. Prior to implementation, the fleet included twenty-five (25) US domiciled companies and two (2) Bermuda companies. As of December 31, 2004, the fleet had been reduced to twelve (12) companies. Phoenix Assurance Company of New York merged into Royal Insurance Company of America. American and Foreign Insurance Company, Globe Indemnity Company and Royal Insurance Company of America were then merged into the Company. Prior to the merger of Globe Indemnity into the Company, Royal Lloyd's of Texas entered into a Reinsurance Assignment and Assumption Agreement transferring all of its assets and liabilities to Globe Indemnity Company. Royal Lloyd's of Texas was dissolved effective September 30, 2004.

## NAIC RATIOS

The Company's 2004 NAIC Financial Ratios from the Insurance Regulatory Information System (IRIS Ratios) were reviewed and it was noted that the Company had received unusual values for five of the ratios. These included the Change in Surplus, Change in Writings, Investment Yield, Liabilities to Liquid Assets and the Two Year Operating Results. For 2003, the Company received four (4) unusual values for Two-Year Reserve Development to Policyholder Surplus, Investment Yield, Change in Writings and the Two-Year Operating Ratio. The unusual values were caused primarily by the decision to cease new business and the sale of the renewal rights for the majority of the Company's business.

## REINSURANCE

Assumed

As the lead company within the pool, the Company assumes reinsurance from affiliates. At year-end 2004, the assumed premiums from affiliates amounted to $533,320,705. The Company also assumed $26,832,451 in reinsurance premiums from non-affiliated insurers, mainly pools and associations.

Ceded

At December 31, 2004, the Company participated in a reinsurance pooling agreement comprised of five members of the Royal Indemnity Pool (Pool). The Company functions as administrator of the pool. Under the arrangement, all underwriting commitments of each member of the pool are 100% reinsured with the Company, which retrocedes to the affiliated companies based on their specified percentage participation in the pool. As of December 31, 2004, the pool participation for each of the companies is as follows:

| Member Companies | State of Domicile | Pooling % |
|---|---|---|
| Royal Indemnity Company | DE | 62% |
| Security Insurance Company of Hartford | CT | 19% |
| The Sea Insurance Company of America | NY | 10% |
| Guaranty National Insurance Company | CO | 5% |
| Viking Insurance Company of Wisconsin | CO | 4% |

In connection with an RBC plan submitted by the Royal Group, Inc., dated March 8, 2005, an amended pooling agreement was entered into effective April 1, 2005. Effective that date, the three remaining pool members, along with their respective pool percentages are: Royal Indemnity Company at 70%, Security Insurance Company of Hartford at 25% and Guaranty National Insurance Company at 5%.

Total net written premium included for the pool companies for calendar year 2004 was $204,521,165, with the major lines of business being Private Passenger Auto liability (154%) and Auto Physical Damage (43%). The total of all other lines of business was negative (-97%). At December 31, 2004, the Royal Group is in run-off mode for all other lines of business except for Private Passenger Auto liability and Auto Physical Damage. This accounted for the significant negative net premium written in the other lines of business.

The largest net aggregate amount insured in any one risk, excluding Workers' Compensation, is $3,100,000. The Company maintains treaty reinsurance on an excess of loss basis for property, casualty and marine exposures. Property catastrophe reinsurance is in place, with a limit of $150,000,000 in excess of $20,000,000, with the $150,000,000 90% reinsured. Property per risk run-off coverage is subject to a limit of $195,000,000 over a $5,000,000 net retention with varying co-participation in the first three of five layers. Casualty clash coverage in run-off is reinsured in four layers up to a limit of $45,000,000 in excess of a net retention of $5,000,000, and a 23.5% co-participation in the first layer of $5,000,000 excess of retention. Workers' Compensation run-off coverage is reinsured with a limit of $95,000,000 in excess of $5,000,000 retention. An aggregate terrorism treaty provided reinsurance coverage up to $345,000,000 over a $25,000,000 retention with varying co-participation in the seven layers over the $25,000,000 retention. Of the original reinsurance coverage for this treaty only $100,000,000 in the first two layers excess of $25,000,000 retention remained in force at December 31, 2004.

Specialty casualty run-off coverage provides reinsurance of $11,000,000 in excess of $1,000,000 retention with co-participation varying depending on the business written. Specialty property coverage in run-off is reinsured up to $14,800,000 above $200,000 retention in three layers with a 40% co-participation in the first layer of $1,300,000 excess of $200,000 retention.

Casualty run-off coverage for Grocers provides reinsurance of $11,000,000 in excess of $1,000,000 retention with a 10% co-participation in the excess. Commercial lines umbrella coverage of $6,000,000 in excess of $4,000,000 is in run-off along with personal lines umbrella coverage of $5,000,000 in excess of $5,000,000. Specialty marine coverage in run-off is reinsured in four excess layers up to $19,500,000 in excess of $500,000 retention. A casualty excess of loss agreement in run-off covering business written by Design Professional Insurance Group provides $9,000,000 reinsurance in excess of $1,000,000 retention with 25% co-participation.

Effective September 30, 2003, the Company entered into an aggregate excess of loss reinsurance agreement with Royal & SunAlliance Insurance plc of the United Kingdom (RSAUK), an upstream parent of the Company. The agreement provides the Company with up to $1.225 billion in excess of loss coverage in excess of an attachment point of $625,300,000. The premium for this coverage is $962,000,000, the attachment point being 65% of premium. The premium is retained by the Company in a trust account at JP Morgan Chase Bank. The Company is allowed a ceding commission equal to 35% of premium, or $336,700,000. $288,600,000 of this commission is immediately earned. The other $48,100,000 was to be paid to the Company on a prorated basis in proportion to the loss paid by RSAUK, and is included with the net premium of $625,300,000 in order to calculate the amount of interest due on funds withheld. The original amount of funds withheld then is $625,300,000 plus $48,100,000, for a total of $673,400,000 at inception. As this coverage pertains to pool business, each of the pool companies record their proportionate share of the business ceded under this agreement.

The Delaware Department of Insurance approved the execution of the agreement on December 23, 2003, and also recognized it as prospective reinsurance on December 29, 2003. As of December 31, 2004, the Company had ceded the entire $1.225 billion of excess coverage to RSAUK. Along with holding the premium in the funds held account, the Company also received a letter of credit for $600,000,000 from RSAUK to secure the reserves ceded to an unauthorized reinsurer.

It was noted that an affiliated agreement, between the Company and Royal SunAlliance Limited of the UK, had not been approved by the Delaware Department of Insurance. The reinsurance agreement was effective on January 1, 1993, and amended to include a letter of credit and funds held provision on December 1, 1996. Title 18, Section 5005 of the Delaware Insurance Code requires that all reinsurance agreements above a materiality limit be submitted for approval to the Department. Total liabilities ceded under this agreement at December 31, 2004 were $284,278,000 per Schedule F, Part 3.

**In accordance with Title 18, Section 5005 of the Delaware Insurance Code, it is recommended that the Company obtain approval from the Delaware Department of Insurance for its 100% quota share reinsurance agreement with Royal and SunAlliance Reinsurance Limited, an affiliated company.**

## FIDELITY BONDS

Royal & SunAlliance USA, Inc. has obtained fidelity coverage through a Financial Institution Bond (Form 25) as well as First and Second Excess Follow Form additional coverage. The underlying bond provides fidelity protection for a single loss liability limit of $5,000,000 and an aggregate amount of $10,000,000, with a single loss deductible amount of $500,000 against loss resulting from dishonest or fraudulent acts of its directors, officers and employees. A First

Excess Follow Form Bond covers a single loss limit of $5,000,000 and an aggregate loss limit of $10,000,000 with a single loss deductible amount of $500,000. A Second Excess Follow Form Bond covers a single loss limit of $40,000,000 and an $80,000,000 aggregate excess of $10,000,000 single loss with a $20,000,000 aggregate, with an excess deductible of $500,000.

The limits of coverage in the current bond meet the amount of fidelity bond insurance suggested by the NAIC Financial Examiners' Handbook.

Other Insurance Coverages

The Company was a named insured on all other insurance policies issued in the name of the Company group, Royal & SunAlliance USA, Inc. Royal and SunAlliance maintains three programs of insurance. Programs included are; (1) Property, (2) Casualty, and (3) Combined Specialty Liability. The limits of liability, as of the examination date, were deemed sufficient. Royal and SunAlliance insuring agreements included: property damage, business interruption, transit (inland and marine) risks, general liability, auto liability, workers' compensation, employer's liability, combined specialty insurance that includes directors and officers liability, and professional liability (errors and omissions).

## ACCOUNTS AND RECORDS

The Company reports all financial accounting transactions on the Oracle General Ledger (OGL), which was implemented January 1, 2001. The OGL is part of the new Royal Financial System (RFS), which has replaced the previous financial systems used by Royal (GEAC), Orion Capital (Oracle) and Orion Auto (Lawson). RFS resides in a client/server environment that uses an Oracle database for information storage. The major components of RFS are three modules of

Oracle applications: Oracle General Ledger, Oracle Accounts payable and Oracle Fixed Assets. OGL is the official book of records for all financial accounting operations. Accounting activity is recorded via automated interfaces from the front-end systems (primarily premium & claims for insurance activity and payroll & accounts payable systems for expenses). Authorized employees have the ability to enter manual journal entries. Entries are reviewed and posted by management.

Automated systems are utilized to capture and report most direct business. Automated interfaces are used to record results on a monthly basis to the GL. The primary direct premium systems are CLS, PMS and Phoenix. The primary direct claims systems are CLASS, CPMS/PMS and Phoenix. Home office and branch personnel in underwriting and claims enter data to these systems.

Monthly reconciliations of the general ledger to individual supporting account detail ledgers are performed by the various departments involved. General ledger account balances were traced to amounts reported in the annual statement for the year under examination. Further detail analysis was performed on the individual accounts throughout the examination.

A review of the controls in information systems was performed by INS Services, Inc. The following recommendations were noted as result of the review:

**Operations Controls - Section E**

Systems Engineers at the secondary data center were unable to produce a standard set of procedures for routine operations.

**It is recommended all data center facilities maintain standard operating procedures including, at a minimum, the following:**

- **Data Center security controls and procedures**
- **Data Center access (who is permitted access and how do they receive authorization)**
- **Tape backups and off-site transfers**
- **24x7 coverage and after hours escalation procedures**
- **Coordination of disaster/business resumption planning**

**It is recommended that the Company should ensure that these procedures are updated as needed and distributed to the appropriate personnel.**

**Documentation Controls - Section G**

The Company's System Development Life Cycles lay out specific documents required prior to moving to the next phase of a project. IT personnel must complete a check-off list, which is reviewed prior to implementation, for most applications, particularly those utilizing the Work Management System (WMS). However, the Company was unable to provide evidence of the use of a documentation check-off list for one of the three IT areas.

These controls help ensure that accurate and relevant documentation is prepared for all new systems and for changes to existing systems and/or programs. Maintaining comprehensive documentation is critical to maintaining standards and quality. Once maintained, the documentation should be periodically reviewed to ensure that it is up to date and accurate.

**It is recommended the Company utilize a documentation check-off list for all applications and IT areas to ensure that all required documentation is prepared and approved prior to implementation for all new systems and changes to existing systems and/or programs.**

**Logical and Physical Security Controls - Section I**

During our testing of application controls, it was determined that certain system parameters did not conform to industry best practices.

**It is recommended that the Company maintain and follow industry standards for setting system parameters.**

## Contingency Planning Controls - Section J

While on-site at the secondary data center, the Company was unable to produce a current disaster recovery plan for one of the financially significant applications and corresponding databases. The Company advised that tests of existing procedures had not been conducted since March 2002. Although the application had undergone significant design changes since that time and has major dependencies on its databases, as well as one of the mainframe applications, the Company does not test these systems simultaneously to ensure that functionality could be restored in a timely fashion.

Disaster simulation testing is the only way to ensure the effectiveness of disaster recovery procedures. The Company has indicated that one of its applications is fully automated and that any unscheduled downtime will have a direct financial impact. Without current and well designed recovery plans, such downtime may be considerable.

**It is recommended the Company develop and implement formal disaster recovery plans for all applications and systems, specifically the Autolink application. Recovery tests should be conducted for the Englewood facility in light of significant changes to staff, infrastructure and critical components of the Autolink application since the last test. In the event a test cannot be scheduled within a reasonable time frame, we recommend the Company conduct paper and off-line data recovery tests to ensure the practicality of existing plans.**

## E-Business Controls - Section K

Observation of the backup logs for the web servers in the secondary facility revealed that some servers exhibited repeated failures. The Company advised that the backup windows were sometimes too small to permit the completion of the backups.

This condition poses the risk that the web servers, although redundant, may not be readily recovered from tape backups in the event of a catastrophe. The failure of multiple servers will result in direct financial impact, as some underwriting functions are completely reliant on the web services. Mirrored servers may be helpful if only one server fails, but may not be of much use in the event of a disaster or the implementation of a change to source code or system software that causes a problem in the live environment, especially after the mirroring has already occurred.

**It is recommended the Company enhance the backup process for its applications and other servers to maintain the reliability of tape backups. Where circumstances hinder the ability to successfully backup critical servers, the Company should work to develop a means to compensate for these factors. With regard to the small backup window available for some applications, a separate procedure should be developed and documented to compensate for this issue, possibly through server rotation.**

## FINANCIAL STATEMENTS

The following statements show the assets, liabilities, surplus and other funds of the Company, as determined by this examination, as of December 31, 2004:

Analysis of Assets
Liabilities, Surplus and Other Funds
Summary of Operations
Capital and Surplus Account
Schedule of Examination Adjustments

It should be noted that the various schedules and exhibits might not add to the totals shown due to rounding. Write-ups on the individual accounts in the Notes to the Financial Statements section of this report are presented on the "exception basis". Only comments relative to adverse findings, material financial changes, or other significant regulatory concerns are noted.

## Analysis of Assets
December 31, 2004

| | Ledger Assets | Assets Not Admitted | Net Admitted Assets | Note |
|---|---|---|---|---|
| Bonds | $3,153,685,559 | $0 | $3,153,685,559 | *1* |
| Preferred Stock | 73,261,510 | 0 | 73,261,510 | |
| Common Stock | 534,498,838 | 0 | 534,498,838 | |
| Mortgage Loans | 35,648,753 | 0 | 35,648,753 | |
| Real Estate | 7,650 | 0 | 7,650 | |
| Cash and short-term investments | 333,595,291 | 0 | 333,595,291 | *2* |
| Other Invested Assets | 10,920,383 | 0 | 10,920,383 | |
| Receivable for Securities | 171,021 | 0 | 171,021 | |
| Investment Income Due and Accrued | 29,658,031 | 0 | 29,658,031 | |
| Agents' Balances or Uncollected Premiums | 140,996,210 | 20,659,011 | 120,337,199 | |
| Reinsurance Recoverables from Reinsurers | 355,650,740 | 1,893,791 | 353,756,949 | *3* |
| Funds held by or Deposited with Reinsured Companies | 2,296,271 | 0 | 2,296,271 | |
| Current Federal and Foreign Income Tax Recoverable and Interest Thereon | 14,105,383 | 0 | 14,105,383 | *4* |
| Net Deferred Tax Asset | 470,221,271 | 470,221,271 | 0 | |
| Guaranty funds receivable or on deposit | 693,234 | 0 | 693,234 | |
| Electronic data processing equipment | 549,013 | 362,677 | 186,336 | |
| Furniture and Equipment, including Health Care Delivery Assets | 2,674,624 | 2,674,624 | 0 | |
| Receivable from parent, subsidiaries and affiliates | 15,582,816 | 49,583 | 15,533,233 | *5* |
| Other Assets non-admitted | 2,115,931 | 2,115,931 | 0 | |
| Aggregate write-ins for other than invested assets | 109,934,596 | 14,248,533 | 95,686,063 | |
| Total Assets | $5,286,267,125 | $512,225,421 | $4,774,041,704 | |

## Liabilities, Surplus and Other Funds
## December 31, 2004

| | | Note |
|---|---|---|
| Losses | $ 1,748,152,922 | *6* |
| Reinsurance payable on paid loss and loss adjustment expenses | 72,720,599 | |
| Loss adjustment expenses | 548,381,864 | *6* |
| Commission payable, contingent commissions and other similar charges | 11,975,806 | |
| Other expenses | 28,120,109 | |
| Taxes, licenses and fees | 22,765,410 | |
| Unearned premiums | 109,590,187 | |
| Ceded reinsurance premiums payable | 38,606,598 | |
| Funds held by company under reinsurance treaties | 974,955,119 | |
| Amounts withheld or retained by company for account of others | 17,466,367 | |
| Provision for reinsurance | 81,354,939 | *7* |
| Aggregate write-ins for liabilities | 226,413,326 | |
| Total Liabilities | $ 3,880,503,246 | |
| Aggregate Write-ins for Special Surplus Funds | $ 371,814,000 | |
| Common capital stock | 5,000,000 | |
| Gross paid in and contributed surplus | 2,183,829,100 | |
| Unassigned funds (surplus) | (1,667,104,642) | |
| Total Surplus as Regards Policyholders | $ 893,538,458 | |
| Total Liabilities, Surplus and Other Funds | $ 4,774,041,704 | |

## Summary of Operations
## December 31, 2004

| | |
|---|---|
| Income: | |
| Premiums earned | $ 538,172,748 |
| Net investment income earned | 113,335,986 |
| Net realized capital losses | (285,013,168) |
| Other income expense | (113,971,772) |
| Total Income | $ 252,523,794 |
| Expenses: | |
| Losses incurred | 526,392,138 |
| Loss expenses incurred | 196,226,331 |
| Other underwriting expenses | 152,232,101 |
| Aggregate Write-ins for Underwriting Deductions | 1,230,287 |
| Dividends to Policyholders | 916 |
| Federal and Foreign Income Tax Incurred | 2,180,453 |
| Total Expenses | $ 878,262,226 |
| Net Income (loss) | $ (625,738,432) |

## Capital and Surplus Account
## December 31, 2003 to December 31, 2004

| | | |
|---|---|---|
| Capital and Surplus, December 31, 2003 | | $ 1,234,218,748 |
| Net Income | | (625,738,432) |
| Additions: | | |
| Change in Net Unrealized Capital Gains | | 268,343,306 |
| Change in Net Unrealized Foreign Exchange Capital Gains | | 211,391 |
| Change in Net Deferred income tax | | 193,038,944 |
| Surplus paid in | | 20,000,000 |
| Deductions: | | |
| Change in non-admitted assets | (159,387,138) | |
| Change in provision for reinsurance | (37,148,361) | |
| Total Deductions | | (196,535,499) |
| Capital and Surplus, December 31, 2004 | | $ 893,538,458 |

## Schedule of Examination Adjustments

(There were no examination adjustments made.)

## NOTES TO THE FINANCIAL STATEMENTS

**Note. 1 Bonds** **$3,153,685,559**

The Company responded "YES" to number 19.1 of Company's Annual Statement General Interrogatories. Based on the examiner's review of the NAIC Annual Statement Instructions, the Company should have replied "No" and included a disclosure in 19.2 pertaining to loaned securities, including the amount loaned as of December 31, 2004.

In discussions with the Company, Company indicated that they responded "Yes" because the securities loaned are under their exclusive control. Based on the examiner's review and interpretation of the Securities Lending Agreement, examiner agrees that securities are under the Company's exclusive control; however, disclosure is not properly made in accordance with the NAIC Annual Statement Instructions.

The NAIC Annual Statement Instructions for the General Interrogatories – Part 1-Common Interrogatories - Investments, states:

> "19. For the purposes of this interrogatory, "exclusive control" means that the company has the exclusive right to dispose of the investment at will, without the necessity of making a substitution therefore. For purposes of this interrogatory, securities in transit and awaiting collection, held by a custodian pursuant to a custody arrangement or securities issued subject to a book entry system are considered to be in actual possession of the company.

If bonds, stocks and other securities owned December 31 of the current year, over which the company has exclusive control, except as shown by Schedule E, Part 3, are: (1) securities purchased for delayed settlement, or (2) loaned to others, the company should respond "no" to 19.1"

**It is recommended that the Company properly disclose loaned securities in accordance with SSAP No. 18 of the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statements Instructions.**

**Note 2. Cash, Cash Equivalents and Short Term Investments $333,595,291**

The Company had a number of bank accounts that included signatory cards with signers that are no longer with the Company and/or not on the resolution designating the authorized signers.

**It is recommended that the Company review the authorized signers on all its bank accounts to ascertain that the authorized signers are currently officially authorized by the Company.**

**Note 3. Amounts Recoverable from Reinsurers $353,756,949**

Note 23A in the Royal Indemnity Company 2004 annual statement shows unsecured aggregate recoverables of $1,012,735,000. This amount should have been $986,325,000, which is $26,410,000 less than the amount reported by the Company. There were two entries for Federal Insurance Company in the 2004 annual statement Note 23A. The first entry with an amount of $26,410,000 is the same amount as reported in 2003, and was inadvertently carried over from the 2003 annual statement.

**It is recommended that the Company prepare its annual statements in accordance with the NAIC Annual Statement Instructions for Property and Casualty Companies (as required pursuant to Section 526 of the Delaware Insurance Code).**

**Note 4. Current Federal and Foreign Income Tax Recoverable $14,105,383**

The Company's tax allocation agreement calls for settlement of inter-company tax balances within 30 days of filing the consolidated federal income tax return or receiving a tax refund if a refund is due. SSAP No 10 of the NAIC Accounting and Procedures Manual requires settlement of federal income tax receivables and payables between affiliates within 90 days of filing the consolidated federal income tax return (or receipt of refund). The 2003 tax return was filed on September 15, 2004. Settlement of balances due to/from The Sea Insurance Company of America, Viking Insurance Company of Wisconsin, and Royal Insurance Company of America were not made within 90 days of receipt of the refund. It was noted that the 2003 recoverables for The Sea Insurance Company of America and Viking Insurance Company of Wisconsin and Royal Insurance Company of America were still outstanding as of August 2005.

**Federal income tax receivables and payables should be settled in a timely manner in compliance with the Company's tax allocation agreement and pursuant to SSAP No 10 of the NAIC Accounting and Procedures Manual.**

**Note 5. Receivable from Parent, Subsidiaries and Affiliates $15,533,233**

The Company has failed to abide by the settlement terms of the various related party contracts that were in place as of December 31, 2004. Those contracts were:

- Administrative Services and Expense Sharing Agreement – settlements should be within 30 days following the preceding quarter.
- Reinsurance Pooling Agreement – due 45 days after the close of the preceding quarter.
- Investment Management Agreement – Paid quarterly to be settled 30 days from invoice date.

**It is recommended that the Company abide by the terms set forth in its related party agreements, and settle the balances within the period allowed per those agreements.**

**Note 6. Losses** **$1,748,152,922**
**Loss Adjustment Expenses** **548,381,864**

A consulting actuary was retained by the Delaware Insurance Department to conduct a review of the Company's reserving methodologies and adequacy. The actuarial staff at the Company provided the consulting actuary with their statement of actuarial opinion and the supporting actuarial data and documents. The consulting actuary's review consisted of separately analyzing the pool's book of business on both a net and gross basis (via a ceded reserve analysis approach) for loss and defense and cost containment (DCC) expense. For adjusting and other (A&O) expense reserves, the consulting actuary performed an independent analysis on an all lines basis. The examiners reviewed samples of claim and policy files in order to test the underlying data supporting the reserves. No material exceptions were noted during that review.

*Summary of Findings*

Per the actuarial review, which was performed by INS Consultants, Inc., required net loss and LAE reserves were $42.6 million higher than the Pool's booked net loss and LAE reserves of $3,915.9 million. The Company's portion of the deficiency represents 62% of the $42.6 million. Because the consulting actuary's estimate was within 1.1% of the Pool's booked reserves, no adjustment will be made to the Company's reserves.

**Note 7. Provision for Reinsurance** **$81,354,939**

It was noted during the review of Schedule F, Part 3, of the Company's 2004 Annual Statement that the Company deducted $31,404,328 for uncollectible IBNR reinsurance for

Authorized Other Non-US Insurers, and $21,443,464 for uncollectible IBNR reinsurance for Unauthorized Other Non-US Insurers. The Company also deducted $5,847,000 for uncollectible paid losses for Authorized Other Non-US Insurers and $27,436,646 for uncollectible paid losses for Unauthorized Other Non-US Insurers. The total unauthorized of $48,880,110 was reduced by 20% of paid losses on unauthorized reinsurers, or $5,487,329. The net of these amounts was $43,392,781 ($48,880,110 - $5,487,329), and was recorded as a bulk reduction to Sch F, Part 5, column 17 for ZZ-Uncollectible. When posting the uncollectible balance, the Company posted the total amount to Paid Losses and IBNR instead of where they were originally recorded.

SSAP 62, paragraph 56 stipulates that the Company should write off uncollectible recoverables through the accounts, exhibits and schedules in the same manner as they were originally recorded (that would be on an individual basis and not in bulk). The company has followed this procedure for the last two examination periods, and has been cited for not complying with the SSAP in the last two exam reports.

**It is again recommended that the Company write off the recoverables deemed uncollectible through the accounts, exhibits and schedules which they were originally recorded per the NAIC Accounting Practices and Procedures Manual, SSAP 62, paragraph 56 and the NAIC Annual Statement Instructions for Property and Casualty Companies as required by Section 526(a) of the Delaware Insurance Code. Alternately, the Company should request a permitted practice if it decides to continue to use this method of recording uncollectible reinsurance.**

## COMPLIANCE WITH PRIOR EXAMINATION RECOMMENDATIONS

The Company has complied with all prior examination recommendations except where specifically mentioned in the "Notes to the Financial Statements" and "Summary of Recommendations".

# SUMMARY OF RECOMMENDATIONS

## Management and Control

As noted during this examination, as well as the previous examination, it is recommended that the Company make appropriate notifications of changes in its executive officers and directors as required by Section 4919 of the Delaware Insurance Code. (Page 9)

## Reinsurance

In accordance with Title 18, Section 5005 of the Delaware Insurance Code, it is recommended that the Company obtain approval from the Delaware Department of Insurance for its 100% quota share reinsurance agreement with Royal and SunAlliance Reinsurance Limited, an affiliated company. (Page 24)

## Accounts and Records

### *Operations Controls*

It is recommended all data center facilities maintain standard operating procedures including, at a minimum, the following: Data Center security controls and procedures; Data Center access (who is permitted access and how do they receive authorization); Tape backups and off-site transfers; 24x7 coverage and after-hours escalation procedures; and coordination of disaster/business resumption planning. (Page 26)

It is recommended that the Company should ensure that these procedures are updated as needed and distributed to the appropriate personnel. (Page 27)

### *Documentation Controls*

It is recommended the Company utilize a documentation check-off list for all applications and IT areas to ensure that all required documentation is prepared and approved prior to implementation for all new systems and changes to existing systems and/or programs. (Page 27)

### *Logical and Physical Security Controls*

It is recommended that the Company maintain and follow industry standards for setting system parameters. (Page 28)

### *Contingency Planning Controls*

It is recommended the Company develop and implement formal disaster recovery plans for all applications and systems, specifically the Autolink application. Recovery tests should be conducted for the Englewood facility in light of significant changes to staff, infrastructure and

critical components of the Autolink application since the last test. In the event a test cannot be scheduled within a reasonable time frame, we recommend the Company conduct paper and off-line data recovery tests to ensure the practicality of existing plans. (Page 28)

***E-Business Controls***

It is recommended the Company enhance the backup process for its applications and other servers to maintain the reliability of tape backups. Where circumstances hinder the ability to successfully backup critical servers, the Company should work to develop a means to compensate for these factors. With regard to the small backup window available for some applications, a separate procedure should be developed and documented to compensate for this issue, possibly through server rotation. (Page 29)

**Notes to the Financial Statements**

***Bonds***

It is recommended that the Company properly disclose loaned securities in accordance with SSAP No. 18 of the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statements Instructions. (Page 34)

***Cash***

It is recommended that the Company review the authorized signers on all its bank accounts to ascertain that the authorized signers are currently officially authorized by the Company. (Page 34)

***Amounts Recoverable from Reinsurers***

It is recommended that the Company prepare its annual statements in accordance with the NAIC Annual Statement Instructions for Property and Casualty Companies (as required pursuant to Section 526 of the Delaware Insurance Code). (Page 34)

***Current Federal and Foreign Income Tax Recoverable***

Federal income tax receivables and payables should be settled in a timely manner in compliance with the Company's tax allocation agreement and pursuant to SSAP No 10 of the NAIC Accounting and Procedures Manual. (Page 35)

***Receivable from Parent, Subsidiaries and Affiliates***

It is recommended that the Company abide by the terms set forth in its related party agreements, and settle the balances within the period allowed per those agreements, as noted in the prior examination. (Page 36)

***Provision for Reinsurance***
As noted during this examination, as well as the previous examination, it is again recommended that the Company write off the recoverables deemed uncollectible through the accounts, exhibits and schedules which they were originally recorded per the NAIC Accounting Practices and Procedures Manual, SSAP 62, paragraph 56 and the NAIC Annual Statement Instructions for Property and Casualty Companies as required by Section 526(a) of the Delaware Insurance Code. Alternately, the Company should request a permitted practice if it decides to continue to use this method of recording uncollectible reinsurance. (Page 37)

## CONCLUSION

The following schedule shows the results of this examination and the results of the prior examination with changes between the examination periods:

| Description | December 31, 2004 | December 31, 2001 | Increase |
|---|---|---|---|
| Assets | $4,774,041,704 | $2,357,184,712 | $2,416,856,992 |
| Liabilities | 3,880,503,246 | 2,028,860,493 | 1,851,642,753 |
| Capital and Surplus | 893,538,458 | 328,324,219 | 565,214,239 |

The assistance of Delaware's consulting actuarial firm, INS Consultants, Inc. and INS Services, Inc. is acknowledged.

Respectfully submitted,

James Call

James D. Call, CFE
Examiner In-Charge
State of Delaware
Northeastern Zone, NAIC

August Plozizka, CFE
Senior Examiner
State of California
Western Zone, NAIC

## SUBSEQUENT EVENTS

Immediately subsequent to the date of this examination several significant changes occurred in the Royal & Sun Alliance Insurance Group's (RSA) holding company organization, primarily as a result of the pool's poor operating performance. Royal Indemnity Company and two other pool participants did not meet their Company Action Level RBC as of December 31, 2004. As a result of this condition, the Company was required to formulate a Risk Based Capital Plan to provide additional capital for the pool.

In accordance with the RBC plan, the nonstandard auto business written by Guaranty National Insurance Company (GNIC), Peak Property and Casualty Insurance Company (Peak) and Viking Insurance Company of Wisconsin (Viking) were sold to an outside third party. In order to effectuate the sale, the following transactions occurred in 2005:

Effective April 1, 2005, the pooling agreement was amended and a Commutation and Release Agreement was entered into that terminated the participation of The Sea Insurance Company of America (Sea) and Viking Insurance Company of Wisconsin. The Company's and Security Insurance Company of Hartford's (SICH) participation in the pooling arrangement increased from 62% to 70% and 19% to 25% respectively. GNIC's participation remained the same. Both the Sea and Viking retained the assets and liabilities associated with the business

written and assumed by them before de-pooling. This change, along with the change in pooling percentage, resulted in a $141.9 million receivable for the Company as of April 1, 2005.

Also effective April 1, 2005, Peak terminated its 100% Quota Share Reinsurance Agreement with GNIC for policies with an inception date of April 1, 2005 or later. Peak then entered into a 100% Quota Share Reinsurance Agreement with Viking for the policies with inception dates of April 1, 2005 or later. The Company entered into a Reinsurance Assignment and Assumption Agreement under which the Company assumed all liabilities of Sea prior to April 1, 2005. Viking and Royal & SunAlliance Insurance plc (RSAUK) entered into a Non-Standard Auto Quota Share Reinsurance Agreement for all non-standard auto business written or assumed by Viking with effective dates of April 1, 2005 or later. Effective November 1, 2005, as a result of the sale of the Non-standard Auto business, this contract was commuted.

On May 23, 2005, GNIC made a dividend all of its common shares of Peak to OrionAuto, Inc. OrionAuto, Inc. then contributed the common shares of Peak to Viking. The value of Peak for both transactions was $10 million. On May 24, 2005, OrionAuto, Inc. made a dividend all of its common shares of Viking to the Company (57,900 common shares) at a value of $23.8 million and to SICH (42,100 common shares) at a value of $17.3 million in proportion to the Company's and SICH's ownership of OrionAuto, Inc. The Company and SICH then sold their outstanding shares of common stock of Viking to the Royal Group, Inc. (RGI) in exchange for Promissory Notes and a Contingent Payment Rights Agreement. The Company and SICH entered into a Pledge Agreement with RGI to secure RGI's obligation with respect to the Promissory Notes. In addition, on June 1, 2005 RGI secured Letters of Credit issued by National Australia Bank, Ltd., as collateral for the Promissory Notes with the Company and SICH, in the

amounts of $23.8 million and $17.3 million, respectively. The LOCs were adjusted on a quarterly basis based on the net asset value of Viking.

On July 28, 2005, RGI signed a definitive Stock Purchase Agreement to sell its Nonstandard Auto business, including Viking, Peak, Viking County Mutual Insurance Company and the business written by GNIC to Sentry Insurance a Mutual Company. The sale was completed on November 1, 2005. As a result of the sale, the Non-Standard Auto Quota Share Reinsurance Agreement between Viking and RSAUK was commuted. Viking received $23 million in cash from RSAUK. Unearned premium reserves of $3.9 million and loss and LAE reserves of $37.1 million were commuted to Viking.

The Company and SICH received cash in the amount of $122.2 million and $88.9 million, respectively, to settle the Promissory Notes, issued by RGI, and the Contingent Payment Rights Agreement equal to the excess of the aggregate net consideration paid RGI for the sale of the business in excess of the aggregate principal amount of the Promissory Notes.

The Company and SICH entered into a Guaranty Agreement with Sentry Insurance whereby the Company and SICH guarantee RGI's performance under the Stock Purchase Agreement. Assets in the amount of $11.6 million and $8.5 million were pledged by the Company and SICH, respectively. The Pledge Agreement that the Company and SICH had previously entered into to secure RGI's obligations with respect to the Promissory Notes was terminated. The LOCs RGI had secured with National Australia Bank, Ltd., as collateral were also terminated.

GNIC entered into a Quota Share Reinsurance Agreement to cede its non-standard auto business to Sentry Insurance. Unearned premium reserves and loss and LAE reserves of $25.7 million and $64.1 million, respectively, were ceded to Sentry Insurance. Under this agreement,

GNIC will continue to issue non-standard auto business on behalf of Sentry for a period ending no later than December 31, 2006.

On December 29, 2005, a Certificate of Re-domestication was filed with the Connecticut Secretary of the State re-domiciling Guaranty National Insurance Company from the State of Colorado to the State of Connecticut.

Effective December 31, 2005, The Sea Insurance Company of America (The Sea) was merged into Royal Indemnity Company. Prior to the merger, the Company owned a 90% share of The Sea with Security Insurance Company of Hartford owning the remaining 10%. Prior to the merger, the Company purchased Security Insurance Company of Hartford's 10% interest in The Sea.

The sale of Marine Indemnity Insurance Company of America was completed on January 17, 2006. The gain to be realized by Royal Indemnity Company in its first quarter statement is expected to be approximately $2.0 million. Sale was to Upper Hudson Holdings LLC. The Company received the approval of the New York Insurance Department on January 12, 2006.

## LITIGATION ISSUES AND SUBSEQUENT DEVELOPMENT

The Company is a party to various litigation and legal claims, as disclosed in its financial statements. Management believed that if the outcome of some these legal matters were found to be unfavorable, there would be a materially adverse impact on the financial position or results of operations of the Company. For these various actions it appears that the Company has reserved for such contingencies appropriately. In accordance with NAIC *Annual Statement Instructions*, the Company has made adequate disclosure of its material contingent liabilities where required.

As of December 31, 2004 several cases are worthy of note. Following is an overview of various legal matters and subsequent development following year-end:

**World Trade Center** – The Pool incurred losses as a result of the September 11 attack. Losses recognized by the Pool as a result of the event include a mix of property, liability and workers compensation claims, but mostly property. The Pool had net losses of $363 million which have been recognized in the financial statements: $258 million in 2001, $105 million in 2002 and $-0- in 2003 and 2004. Recognized paid and unpaid reinsurance recoveries totaled $1,148 million. The Pool has written off $3 million of uncollectible reinsurance as of December 31, 2004. The Pool continues to litigate on its coverages. Depending on the outcome of the litigation, the Pool could be exposed again to the remaining aggregate coverage limits. An unfavorable outcome may have a material adverse effect on the financial condition of the Pool Companies.

In the coverage litigation on the Silverstein / WTC Properties insurance program, the program provided total per occurrence limits of $3.55 billion, in a twelve-layered structure, in which numerous insurance carriers participated for varying amounts in on or more layers of the program. The Company was bound to coverage through two separate internal business units, Risk Management & Global ("RMG") and Royal Specialty Underwriting Inc. ("RSUI"). RMG bound the Company to $50.4 million, part of the $993 million Ninth Excess Layer attaching at $2.5 billion. The RMG binder was determined by summary judgment to have been subject to a single occurrence only. The RMG limit has been paid and is no longer part of this litigation. The Company was also bound at three layers by RSUI. The RSUI binders are part of the continuing coverage litigation on the Silverstein / WTC Properties insurance program. The per occurrence

limits to which RSUI bound the Company aggregate to $127.8 million as follows: $0.8 million, part of the $10 million Primary layer excess of a $1 million deductible; $2 million, part of the $40 million First Excess layer attaching at $10 million excess of the $1 million deductible; and $125 million, part of the $767 million Ninth Excess layer attaching at $2.5 billion. The Company has already paid the limits of the two lower RSUI binders on a single occurrence basis: $2.8 million. As outlined below, the Company continues to litigate both the number of occurrences applicable to the RSUI binders and also the amount of the claims asserted by the Silverstein / WTC Properties entities against the insurance program. Accordingly, the Company has not paid any portion of the $125m limit of the top RSUI layer. Depending upon the outcome of the litigation with respect to occurrences and claim valuation with per occurrence limits, the Company's remaining exposed limits on the RSUI binders would be either $125 million if subject to a single occurrence, or $252.8 million if subject to a double occurrence ($125 million on the first occurrence and $127.8 million on the second).

The Court defined the following structure for the ongoing Silverstein / WTC Properties coverage litigation:

- *Phase 1* – A jury trial as to which of the several carries participating in the WTC coverage structure were bound to coverage under the Willis Property Endorsement ("WilProp"), and thus subject to ***one*** occurrence for the purpose of determining applicable limits.
- *Phase 2* – A separate jury trial as to the insurance forms to which the non-WilProp carriers were bound and whether such forms are subject to ***one*** or ***two*** occurrences for the purpose of determining applicable limits.

- *Phase 3* – An appraisal before a three-member panel, of the amount of damages compensable under the policies.

**The following events have taken place subsequent to December 31, 2004:**

- *Phase 1 Jury Trial* – The insureds have appealed to the US Court of Appeals for the Second Circuit, from the Phase 1 Judgment to the extent that certain carries were determined to be subject to only a single occurrence; the Company is not involved in the Phase 1 appeals. Briefing on the Phase 1 appeals were completed on December 9, 2005 and oral argument was presented on March 7, 2006. The parties await the Second Circuit's decision, expected in the second half of 2006.
- *Phase 2 Jury Trial* – On December 6, 2004, the carriers participating in the Phase 2 trial (including the Company on the RSUI binders), were determined to be subject to two occurrences. On April 28, 2005, defendants' (including Royal's) post-trial motions for judgment notwithstanding the verdicts ("JNOV") were denied and judgment was entered June 17, 2005. The Company maintains that its RSUI binders should be subject to only a single occurrence and appealed to the US Court of Appeals for the Second Circuit. Other Phase 2 carriers appealed as well. Briefing on the Phase 2 appeals was completed on December 9, 2005. Oral argument was presented on March 7, 2006, the same day as the Phase 1 arguments. A decision is expected in the second half of 2006.

- *Phase 3 Appraisal* – The confidential Phase 3 appraisal hearings continue. The hearing schedule has been extended though 2006, and may be further extended into mid 2007.

**Trustmark** – The Pool is exposed to loss contingencies resulting from certain reinsurance disputes, principally with Trustmark Insurance Company, a life and accident and health insurance company domiciled in Illinois through its participation in programs structured by ARTIS. This dispute was commuted in April 2005, with all parties sharing in settlement. The net effect to the Pool is reported to be a charge of approximately $20 million to surplus.

**Student Finance Corporation** – In 2002, issues arose in connection with a series of credit risk insurance policies covering loans made to students in various post-secondary trade schools, primarily truck-driving schools. The aggregate face value of the loans as of the dates issued was approximately $500 million. In June and July 2002, the Company filed lawsuits in Texas state court seeking, among other things, rescission of these policies in response to a systematic pattern of alleged fraud, misrepresentation and cover-up by various parties, which, among other things, concealed the loan default rate.

MBIA, Wells Fargo, PNC Bank and Wilmington Trust commenced actions on the Company's policies in Delaware. The Company's Texas rescission action was subsequently consolidated with the Delaware actions in US District Court. Summary Judgments were granted to MBIA and Wells Fargo, PNC Bank, and Wilmington Trust. The Company appealed to the US Court of Appeals for the Third Circuit. During the

pendency of the appeals, the Company settled with PNC Bank and Wilmington Trust. The action by MBIA and Wells Fargo continues in litigation.

On October 3, 2005, the Third Circuit affirmed the MBIA and Wells Fargo Judgment as to coverage, but vacated the monetary award and remanded the case back to the US District Court for discovery and rulings as to the scope of coverage afforded by the Company policies and whether all of the claims asserted fell within the scope of coverage. The remand was stayed until April 10, 2006, when the Third Circuit denied the Company's petition for rehearing. The case was formally remanded on April 18, 2006.

On April 20, 2006, MBIA and Wells Fargo moved the District Court for summary judgment arguing that discovery was not needed. The Company opposed the motion. MBIA and Wells Fargo subsequently consented to a period of discovery ending January 26, 2007 and agreed to hold any summary judgment motion in abeyance until the close of discovery.

On April 25, 2006, the Company moved to compel the return of its collateral. Briefing on that motion ends June 12, 2006, and a decision is expected in the summer or fall of 2006.

**Commercial Money Center (CMC) –** This litigation arose from a program in which the Company, and other surety companies, issued bonds securing the payment of approximately 1,500 equipment leases. CMC originated the equipment leases, pooled them into an investment trust and marketed them to investors (primarily banks) in the capital markets. The Company sought, among other things, rescission of the bonds in response to a systematic pattern of alleged fraud, misrepresentation and cover-up by

various parties, which among other things concealed the default rate. The rescission actions gave rise to other related lawsuits seeking to enforce the surety bonds. As of December 31, 2004, the paid on settled pools, the outstanding lease principal on unsettled pools, prejudgment interest on unsettled pools, legal and allocated loss adjustment expenses for CMC was $81.6 million.

**Subsequent to year-end 2004, the following events have taken place:**

*Multi-District Litigation ("MDL")* - On August 19, 2005, the Rule 12 motions by investor banks for judgment on the pleadings in the MDL cases were decided. The court denied the banks' motions as to the sureties (including the Company) that issued bonds on the underlying equipment leases. The Judge held that the court could not rule on the pleadings that, as a matter of law, the banks (rather than CMC) are direct obligees on the surety bonds.

In the August 19, 2005 decision, the Judge suspended all previous MDL discovery timelines pending a further scheduling conference set for September 22, 2005. Fact discovery has been completed but many other scheduling issues remain, including: scheduling of expert disclosure, settling the time frames for amendment of pleadings, dispositive motions, and for eventual remand of the various MDL cases back to their original venues for trial. In subsequent conferences, the Judge deferred scheduling the remaining pre-trial matters pending court sponsored mediations to be held in mid-January 2006.

The parties to the MDL litigation wait the scheduling of expert disclosure and dispositive motions. The Company expects MDL proceedings to continue into 2007.

*CMC/CSC Bankruptcy Proceeding* - On January 28, 2005, a US Bankruptcy Judge granted the Trustee's motion for summary judgment against NetBank and denied NetBank's corresponding motion against the Trustee. The Bankruptcy Court held that NetBank neither owned nor had a perfected security interest in the CMC leases bonded by the Company, and that NetBank therefore could not assert any claims upon the bonds issued by the Company. On April 15, 2005, Judgment was entered upon the January 28 decision. NetBank appealed to the Bankruptcy Appellate Panel for the Ninth Circuit. Oral argument was presented March 23, 2006 and post-argument letter briefing was completed May 2, 2006. The Company expects a decision to be issued in the summer or fall of 2006.

On March 23, 2005, a Global Settlement Agreement ("GSA") was reached in the CMC Bankruptcy proceeding, which encompassed a number of issues with respect to the claims asserted against the Estate. As to the Company, the Trustee agreed to continue to prosecute the avoidance action against NetBank (primarily, fighting NetBank's above-noted appeal) until the Company's bonds in the NetBank leases have been returned to the Company. The GSA was approved by the Bankruptcy Court on May 19, 2005, with an effective date of May 31, 2005. On June 13, 2005, the Trustee issued a series of checks totaling $3.5 million to the Company, as distributions of lease pool funds pursuant to the GSA. On July 27, 2005, the Company received an addition $203,472 as reimbursement for administrative expenses under the GSA. Total GSA payments to the Company were $3.7 million. The Company is also receiving collection monies under the provisions of the GSA; these are running at approximately $10,000 per month. The GSA does affect

NetBank's appeal to the Bankruptcy Appellate Panel, which is described in the preceding paragraph.

As of December 31, 2005, and reflecting the effect of the Global Settlement Agreement, the key figures as to the Company were: $5.8 million paid on settled pools; and $69.4 million in potential exposure on unsettled pools.

**California Class Action Complaint -** A class action complaint was filed against the Company on January 18, 2003, alleging the Company misclassified its California automobile claim examiners as "exempt" employees under California Labor Law and, instead, should have classified them as "non-exempt" employees. Under the Federal Fair Labor Standards Act (FLSA) and California wage and hour statutes, non-exempt employees were entitled to overtime pay for hours worked in excess of 40 hours per week. On September 9, 2003, plaintiffs filed a First Amended Complaint seeking to expand the class definition from only auto claims adjusters in California to all claim adjusters in California. The court allowed the expansion and the additional claimants to join the class retroactively to the commencement of the action. Although the court had not certified the class, the expansion of the proposed class definition increased the maximum potential exposure.

**Subsequent to year-end 2004, the following events have taken place:**

A settlement of the matter was agreed to on March 9, 2005. The written Settlement Agreement was executed by all parties on June 29, 2005 and has received preliminary approval from the Court. Final approval of the settlement was granted in

September 2005 and the settlement became effective on November 11, 2005. Payments to the class members were made in January 2006. This settlement did not have a material adverse impact on the Company.

**General Motors Corporation (GM) -** On October 27, 2004 GM tendered asbestos and environmental claims to the Company and Royal & SunAlliance USA, Inc. (collectively "Royal US"), and Royal & Sun Alliance Insurance Group plc (RSAIG). The Company has reviewed relevant policies, agreements, the history between it and GM, and information provided by GM, and concluded that GM had not demonstrated that it was entitled to coverage for the tendered claims. The Company requested additional supporting information from GM, which was not provided.

**Subsequent to year-end 2004, the following events have taken place:**

On January 26, 2005 the Company commenced an action for declaratory relief in Delaware State Court, and GM filed a corresponding action in Michigan against Royal US and Royal UK companies. Ultimately, the Delaware coverage action was stayed in deference to the Michigan coverage action. In the Michigan action, litigation as to the Royal UK entities was stayed pending outcome of the coverage dispute relating to the Royal US entities.

In August 2005, the Michigan court denied GM's motion for an order directing Royal US to defend GM in its underlying asbestos litigation. Applications for interlocutory appeals must generally be filed within 21 days on entry of an order. GM did not do so. However, in late December 2005, GM did move the Appellate Court for

permission to file a late interlocutory appeal from the duty to defend decision. Royal US has opposed. A decision on that motion may not be issued until late 2006.

In February 2006, GM unsuccessfully tried to disqualify counsel for Royal US.

Discovery is continuing. The Michigan court has prescribed a two phase trial structure for the case. Phase 1 will focus on issues related to policy existence and scope-of-coverage issues, including asbestos. Phase 1 is scheduled for trial in September 2006, but this date is likely to be adjourned to early 2007. Phase 2, if needed, will focus on issues related to coverage for environmental claims. Phase 2 will sequenced to follow Phase 1 and will most likely be heard in late 2007 or early 2008.

In addition to the above mentioned litigation as of December 2004, the following cases have been subsequently added to the Company's docket or were not specifically mentioned in the Notes to Financial Statements in 2004, but were specifically mentioned in the General Counsel's update to the examination dated January 13, 2006:

**Intrepid Re-**In 1999, a subsidiary of Royal (UK), a subsidiary of Aon corporation and Ace Bermuda Insurance Ltd. entered into a shareholders agreement to form an entity known as Intrepid Re Limited, a Bermuda reinsurance company ("Intrepid"). Under that agreement Ace and Royal (UK) each own 38.5 percent of the shares of Intrepid, and Aon owns the remaining 23 percent. On the same date, the Company and a US subsidiary of Ace entered into a separate but identical Quota Share Reinsurance Agreements ("Treaties") with Intrepid, pursuant to which they would cede to Intrepid participation in certain insurance policies placed with Custom Risk Solutions, LLC ("CRS"), as

managing general underwriter. CRS is owned by subsidiary of Royal (UK), Ace and Aon on an equal basis, i.e., one-third each.

There was a dispute between the parties as to whether the following programs bound by CRS fall within the Treaties. The Treaties contemplated automatic cessions of an 80% share participation in Intrepid:

i. Commercial Money Center ("CMC"): *See CMC section above for detail.*

ii. ADP TotalSource ("ADP"): The ADP program provided workers' compensation coverage for ADP TotalSource, an employee leasing company. Coverage was (and is) provided in several layers. At issue in the arbitration is coverage for an aggregate stop loss layer. The Company has not made any payments to date, but projected future payments total $9.4 million. Intrepid's 80% share equals $7.5 million.

A confidential arbitration hearing was conducted in London before a three-member tribunal from September 19-29 2005. On December 7, 2005, the tribunal declared: (1) that the CMC program is not covered; and (2) the ADP program is covered the Company moved for reconsideration as to CMC and for clarification as to the allocation of costs between the parties. On May 22, 2006, the Panel affirmed its findings as to the ADP and CMC programs and allocated costs as between the parties. The effect of the cost allocation was a net payment by the Company to Intrepid of $3 million.